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FRBSF Weekly Letter

International Financial Integration

Much of the current discussion on the international debt problem has concentrated on its immediate causes and possible remedies. This *Letter* proposes that perhaps both the diagnosis of the problem and the prescription for its solution depend critically on how one interprets the international banking developments of the last twenty years.

The conventional view with regard to international banking is that it is a mere extension of domestic banking: banks lend a portion of domestic deposits abroad in pursuit of higher returns. As such, the regulatory and supervisory approach that has been adequate for ensuring prudence in domestic banking should also be sufficient for protecting the banking system from the vagaries of international activities—provided that control over international banking is tightened.

An alternative view puts the international debt problem in the context of the international financial integration that has occurred over the last two decades. Similar to inter-regional financial integration within a national economy, this perspective interprets the international-debt problem as one of international financial management, comparable to that of national financial management.

This *Letter* will attempt to establish that international financial integration is a reality that can be reversed only at great costs to the world economy. Its implications for the international-debt problem will be explored in next week's *Letter*.

The concept
An "integrated financial system" is one in which the savers and ultimate users of funds residing in different regions are guided by essentially the same set of market signals (e.g., interest rates) in making their financial decisions. In the U.S. financial system, for example, competition and the efficient dissemination of information allow savers in different parts of the country to be given essentially the same set of returns for their savings, and borrowers the same set of interest costs. Money-market mutual funds, secondary mortgage markets, insurance companies, national finance companies and investment banks have all helped to ensure that this condition prevails nationwide.

The extent of international financial integration is, of course, far less than that within a nation. In concept, one may recognize three levels of integration. First, at the most underdeveloped level, segregated national markets exist. These may consist of national financial markets effectively separated by capital controls (examples being centrally planned economies) or by prohibitively high information costs (such as those prevailing in poor nations in remote regions). The result is that little if any international private capital flows across national boundaries. Each separate national financial market allocates the national savings among domestic borrowers at interest rates that are completely unaffected by those in the rest of the world, and domestic investment is confined to that which can be financed out of domestic savings.

Second, linked national markets exist where the market participants in each nation have little or no *direct* access to financial services outside their nation's borders, but limited international capital flows take place as permitted by national exchange-control authorities. Capital tends to flow from those countries with a surplus and relatively low rates of return to capital-deficient countries with relatively high rates of return. Since these flows are obstructed, interest rates are not equalized internationally.

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Third, full international financial integration exists where the market participants in different nations have access to the same financial services for borrowing and for placing funds at essentially the same set of interest rates. These financial services are provided by institutions that have acquired expertise in international risk assessment and that have free access to funds in national or international markets. Because of economies of scale and market competition, they can offer higher interest rates to savers and lower rates to borrowers than those operating strictly in national markets.

In contrast to linked national markets, international capital flows in integrated markets are characteristically *two-way flows* between nationals in a country and financial institutions located abroad. Since in this case international banking is a service industry based on financial expertise rather than the relative abundance of national capital, it can be conducted by banks of any nationality that can more ably provide this service, and in any country that enjoys a comparative locational advantage with respect to a given region. Thus, London, the Bahamas, Panama, Hong Kong, and Singapore are international centers with extensive *two-way* international flows, not because of the relative abundance of their domestic capital endowment, but because of the existence of a well-established international banking service industry and their locational advantage.

The evidence

International financial integration is not a new phenomenon. It prevailed to a large extent in the 19th century, when London was the international financial center of the world. The system fell apart during World War I and disintegrated as a result of the Great Depression. It is only in the last twenty years, with the removal of capital controls by major industrial nations and the rise of the Euro-currency markets, that international financial integration has revived.

The pace of the revival has been especially rapid during the past decade. The total international banking assets of fifteen major industrial nations grew from roughly $300 billion at the end of 1974 to almost $1.7 trillion at mid-1983—an average growth rate of 23 percent a year. The bulk of these assets were claims among banks, but as much as $500 billion consisted of loans to foreign governments and businesses. The phenomenon has been worldwide in scope. Banks located in the United States accounted for about one-third of the total assets at mid-1983, and those in Europe about 60 percent, with the rest divided between banks in Japan and Canada.

A necessary and sufficient condition for financial integration is a two-way capital flow between international financial centers and residents outside such centers. At mid-1983, total international banking assets amounted to $1.7 trillion and liabilities, $1.6 trillion. These were banking claims and liabilities involving residents outside the fifteen industrial countries and the offshore financial centers where the banks were located. Most of these two-way international claims and liabilities were in relation to entities within the reporting area. With respect to those outside that area, the banks held a total of $530 billion claims and had $330 billion liabilities.

A further breakdown indicates that this international banking system had two-way financial relations with all major individual "outside" areas or countries. For instance, $79 billion of claims on the OPEC nations and $120 billion of liabilities to them, $48 billion of claims on Asia other than Japan versus $36 billion of liabilities to the region, and $60 billion of claims on Mexico matched with $13 billion of liabilities to that nation. These data sketch out a profile of the current status of international financial integration in the world economy.

Through the international banking system, the fifteen industrial countries and the offshore centers together constitute a highly integrated core, on which is anchored a far-flung two-way financial network covering various parts of the world, with varying degrees of financial integration.

Its significance

The significance of international financial integration can be assessed by examining its benefits and costs. First, international integration increases the efficiency of capital allocation among nations. Instead of confining the investment horizon to the national or regional market, an integrated system allows savers to seek the highest and safest return worldwide, as offered by financial institutions whose business is to know the optimal investment opportunities. Borrowers also benefit by being released from the confines of the national market to seek the lowest cost financing offered in the world market. The result is not only higher returns to savers and lower costs to borrowers, but also greater real income for both the lender and borrower nations than is possible under either segregated or linked national markets. More efficient capital allocation means larger world output of goods and services for distribution to the lender and borrower nations.

Second, an internationally integrated financial system cushions the world economy from unexpected shocks and facilitates the financing of world output and trade expansions. For instance, the world banking system did a remarkably good job in recycling the OPEC surplus dollars following the two large oil-price increases in the 1970s. This gave the importing nations time to adjust their production and consumption structures to the price changes, and thus avert abrupt disruptions to their economies. (A possible adverse effect is that the access to financing may have induced some countries to forego or unduly postpone necessary adjustments.) In addition, the rise of international banking has also been instrumental in financing the tremendous growth in world trade and output in the last twenty years. To the extent that trade benefits all nations, international banking has also benefitted the world economy by making trade growth possible.

However, international financial integration cuts both ways. Increased interdependence also means increased exposure to risks for both the banks and their customers. In addition to ordinary credit risk, international lending exposes banks to political and economic risks in debtor nations over which they have little control. (However, international portfolio diversification reduces total risk.) Moreover, because extensive and massive inter-bank claims closely link the major international banks, a crisis that hits one could also shake up the rest. (On the other hand, the inter-bank market has been a major source of support for banks in temporary liquidity shortages.)

Debtor nations that tie themselves to the world capital market expose themselves to the risks of disrupted flows of funds and large interest-rate fluctuations. When times are good, bankers swarm around, fighting to offer funds, but when conditions sour and financing is desperately needed, funds become scarce quickly. The unwary borrower would then be left in the lurch and be forced to undergo painful deflationary adjustments to make ends meet.

From the viewpoint of an individual nation, are the benefits of international financial integration worth the costs? The question is as irrelevant to a nation as it is to a region within a national economy, for financial integration, international or inter-regional, cannot be reversed without wreaking havoc on the economy. The world tried it in the early 1930s and suffered from a severe world recession that was in part attributable to international financial disintegration. The only relevant question is, therefore, how to manage a partially integrated world financial system to maximize the benefits and minimize the risks.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 11/30/83	Change from 11/23/83	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	163,462	350	763	0.5
Loans (gross, adjusted) — total#	143,476	500	1,330	0.9
Commercial and industrial	43,981	393	– 1,553	– 3.4
Real estate	57,511	11	257	0.4
Loans to individuals	25,250	154	1,610	6.8
Securities loans	2,723	– 107	378	16.1
U.S. Treasury securities*	7,678	– 22	876	12.9
Other securities*	12,306	– 127	– 1,443	– 10.5
Demand deposits — total#	44,023	2,472	474	1.1
Demand deposits — adjusted	29,532	1,232	369	1.3
Savings deposits — total†	66,122	91	33,326	101.6
Time deposits — total#	70,175	– 115	– 27,441	– 28.1
Individuals, part. & corp.	64,478	– 117	– 23,203	– 26.5
(Large negotiable CD's)	17,372	– 112	– 16,876	– 49.3

Weekly Averages of Daily Figures	Week ended 11/30/83	Week ended 11/23/83	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	92	38	139
Borrowings	17	5	43
Net free reserves (+)/Net borrowed(–)	75	33	96

* Excludes trading account securities.
# Includes items not shown separately.
† Includes Money Market Deposit Accounts, Super-NOW accounts, and NOW accounts.

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